MACROECONOMICS

Where Will Fiscal Stimulus Lead G7 Economies?

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The Great Recession has produced a decline of $10 trillion in U.S. household wealth alone, mostly from declines in real estate and equity markets.

Faced with the real possibility of depression and prolonged stagnation, G7 countries have been providing significant countercyclical relief in the form of large-scale fiscal stimulus and financial rescue packages. Given such serious downside risks, substantial discretionary capital injections by government — to substitute for missing capital injections from the private sector — appeared to be a prudent approach for tempering the decline and sowing the seeds of recovery.

But will the forceful fiscal stimulus guarantee a return to growth, or will the cost of the stimulus impede recovery and hamper medium-term prospects?

Most agree that the response by governments and global monetary authorities has helped to stem the economic and financial market turbulence. The once wobbly legs of the economy have been stabilized, at least temporarily, and the banking sector no longer appears in imminent danger of collapse.

These hopeful signs come at a cost. The ongoing stimulus will likely push the U.S. budget deficit for 2009 to about $1.75 trillion, exceeding 12% of U.S. GDP, according to our analysis of International Monetary Fund data.

Why then does the economy remain in such a precarious position? The answer is that while the various policies have offered a glimmer of hope in the short term, the repercussions of such massive fiscal intervention for the intermediate term are unclear.

Upfront discretionary stimulus imposes costs that can only be recovered over time through taxation, rendering the prospects for medium-term economic growth uncertain.

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